

ST 01-12

Tax Type: Sales Tax

Issue: Graphic Arts Exemption

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

"PACIFIC COLOR APPLICATIONS, INC.",

Taxpayer

No. 99-ST-0000
IBT: 0000-0000
NTL: SF-1998000000000000-03

RECOMMENDATION FOR DISPOSITION

Appearances: Mark Dyckman, Senior Counsel, Sales Tax for the Illinois Department of Revenue; Thomas H. Donohoe and Melissa A. Connell of McDermott, Will & Emery for "Pacific Color Applications, Inc."

Synopsis:

This matter comes on for hearing pursuant to the timely protest of "Pacific Color Applications, Inc." ("PCA" or taxpayer) to Notices of Tax Liability issued for the period of July 1, 1981 through April 30, 1998. The issue in this matter is (1) whether the color standards produced by "PCA" qualify for either the graphic arts or the machinery and equipment (MM&E) exemption, 35 ILCS 120/2-5(14) and 2-5(4). After consideration of

the evidence at hearing and the parties' memoranda of law, it is recommended that this matter be resolved in favor of the Department.

FINDINGS OF FACT:

1. As a result of a Department audit, two NTL's were issued to the taxpayer. NTL SF-1998000000000000 was issued on December 28, 1998. The NTL was for \$29,771 in retailers' occupation tax ("ROT"), with \$2,766 in penalties and \$30,990 in interest minus a payment of \$29,771 for a total of \$33,756. This NTL covered the period July 1, 1981 through November 30, 1993. Stip. ¶ 1.
2. NTL SF-1998000000000000 was issued on December 28, 1998. The NTL was for \$96,439 in retailers' occupation tax, with \$2,738 in penalties and \$21,472 in interest minus a payment of \$32,648 for a total of \$88,001. This NTL covered the period December 1, 1993 through April 30, 1998. Stip. ¶ 2. Taxpayer filed timely protests to these NTL's. Stip. ¶ 3.
3. The parties have stipulated that the only issue in this matter involves "PCA's" sales of "color standards" to the "Acme Gum and Baseball Card Company" ("Acme"). If the color standards qualify as graphic arts machinery and equipment or general machinery and equipment, then 93% of the tax base (\$58,208) is exempt under the graphic arts machinery and equipment exemption of the Retailers' Occupation Tax Act, 35 ILCS 120/2-5(4) or the machinery and equipment exemption, 35 ILCS 120/2-5(14). Stip. ¶ 4.
4. "PCA" produces color standards for "Acme" as well as the automobile and the paint industries. Tr. p. 16. Color standards are depictions of the colors that "Acme" uses in its packaging throughout the world. The color standards are used

by the printers and the ink suppliers to ensure consistency in the color of "Acme's" product packaging. Tr. p. 17.

5. "Jane Doe" is the corporate quality assurance ("QA") packaging manager for the "Acme", Company. Tr. p. 24. "Doe" is responsible for the appearance of "Acme" products. She supervises two areas: the color standard division that ensures the consistency of product appearance and the product packaging division which ensures that the gum packages are wrapped correctly. Tr. p. 26.
6. "Acme" has had a color standard program for approximately 20 years. The main purpose of the program is to ensure that the appearance of "Acme's" products is consistent throughout the world. "Acme" utilizes three specific types of color standards: a brand standard, a single color standard and a tolerance chart. Tr. pp. 27, 28. The brand standard displays all of the colors for a particular brand on one or two cards. Tr. p. 27; Taxpayer Ex. No. 1. A single color standard, sometimes called a "9 x 11," displays multiple samples of one color. Tr. pp. 27, 28; Taxpayer Ex. No. 2. The tolerance chart displays the range of color that "Acme" will accept from its printers. Tr. p. 28; Taxpayer Ex. No. 3.
7. When developing a new product, "Acme's" graphics and design department mixes customized colors and print samples for senior management and the marketing groups. Tr. pp. 29, 30. Once a decision is made, a small sample of that color is given to corporate quality assurance. Tr. p. 30.
8. "PCA" mixes paint and pigments to develop a color proof that matches the sample that the customer provides to "PCA". "PCA" then applies and dries the paint onto a backing material that the customer specifies. Tr. pp. 18-20.

9. The color proofs are evaluated by "PCA" both visually and by computer analysis to ensure that the color proof matches the color sample given to "PCA" by the customer. Tr. pp. 19, 20.
10. This color proof is submitted to "Acme" for approval. Tr. pp. 18, 19.
11. "Doe" judges the accuracy of the color both visually and through computer evaluation. Tr. p. 30. Project sheets are used to track QA work during this process. Tr. p. 31.
12. Once "Acme" has accepted a color proof, "PCA" produces the color standards in the quantities per "Acme's" order and ships them to "Acme's" QA department for random sampling both visually and by computer. Tr. p. 35. Once the random testing is completed, the color standards are stored awaiting distribution. Tr. pp. 35, 36.
13. Color standards are ordered in the largest quantities possible to minimize variation. Tr. p. 36. Each color standard (a "9 x 11") costs approximately \$3 a sheet. Tr. p. 36. A brand standard costs approximately \$7 a piece. Tr. p. 37. A tolerance chart costs approximately \$15 a piece. Tr. p. 37.
14. The 9 x 11 color standards and the single color standards are stored in blue storage boxes to keep them dust and dirt free. Tr. p. 37. The blue storage boxes are approximately 10" x 12" x 5" high. The brand standards and the tolerance charts are stored in catalogs in metal file cabinets. Tr. p. 37.
15. Before storage, "Acme's" QA department will label and stamp the standards for tracking purposes. Tr. p. 39.

16. The color standards are used by quality assurance personnel in the U.S. and overseas for inspecting materials as they are brought into the facilities and for distribution to foreign printers. "Acme's" QA department distributes color standards directly to the printers. Tr. p. 40. The color standards are also used at point of purchase displays. Tr. pp. 39, 40.
17. "Acme's" QA department will typically give the printers as many color standards as needed to complete a job. The printers then distribute the standards to their ink suppliers. Typically, three color standards are sent to the ink suppliers, but "Acme" will send them as many as needed. Tr. p. 41.
18. Color standards are stamped with an expiration date of approximately six months to a year. Tr. p. 41.
19. The ink suppliers use the color standards to formulate the ink batches that are used by the printers. Tr. p. 42. The ink suppliers will formulate and evaluate the color of the ink both visually and by computer to create a color proof. Tr. p. 42.
20. The ink suppliers develop a color proof using a color proofing press to minimize variance. Tr. pp. 43, 44. Each ink batch that is produced must have a color proof. Tr. p. 44.
21. The color proofs developed by the ink suppliers are evaluated by the printers. Once agreed upon, the color proofs are evaluated by "Acme's" QA department visually and by computer analysis. Tr. pp. 45, 46. The color proofs are evaluated using "PCA's" color standards. Tr. pp. 45-47.

22. After the ink has been formulated, the printers use the color standards throughout a printing run to ensure the color is correct. Tr. pp. 48-52. The printers also use the color standards to evaluate returned goods. Tr. p. 52.
23. "Acme" notifies the printers approximately one month before the expiration of its color standards. Tr. p. 53.
24. Upon expiration, the color standards are returned to "Acme" to determine if they may continue to be used. Tr. pp. 53, 54. The color standards are either renumbered and recycled or destroyed. Tr. p. 54.
25. The Gravure and Flexography printing processes are used to print the majority of "Acme" packaging. Tr. pp. 54, 55.
26. "Acme" provides a color seminar for its printers, ink suppliers, pressman and the printer's quality assurance personnel to explain the "Acme" color program and the importance of color to "Acme". The color seminars are given approximately once or twice a month. The seminars are conducted at the manufacturing locations. Tr. p. 65.
27. The taxpayer does not contend that the color standards that are used in the display books are exempt under the graphic arts equipment or manufacturing and machinery equipment exemption. Tr. pp. 69, 70.
28. Taxpayer did not charge "Acme" use tax on the sale of the color standards and did not remit ROT on these sales. Tr. p. 21.
29. "PCA" obtained an exemption certificate from "Acme". Tr. p. 21. The exemption certificate stated that "Acme" "believed 93 percent of the color standards to be exempt as equipment essential to our packaging printing production process." Tr.

pp. 21, 22. The remaining seven percent were used for quality assurance purposes.
Tr. p. 22.

30. While the evidence in the record indicates that William "Acme", Jr. Co. provided Color Communications with exemption certificates for the purchases of color standards, taxpayer is not seeking a determination of this matter on that basis. Supp. Stip. ¶ 1.
31. Taxpayer seeks a substantive determination solely on whether its sales of color standards qualify for either the "graphic arts exemption" or the "manufacturing, machinery and equipment" exemption; thus, taxpayer waives any arguments regarding a determination of this matter based on the existence of the exemption certificates. Supp. Stip. ¶ 2.
32. Neither "Pacific Color Applications, Inc." nor "Acme Gum and Baseball Card Company" depreciated the "color standards" as fixed assets on their corporate federal income tax returns during the relevant period. Stip. ¶ 5.

CONCLUSIONS OF LAW:

Pursuant to 35 ILCS 120/4, the Correction of Returns submitted as Dept. Group Ex. 1 are *prima facie* correct and constitute *prima facie* evidence of the correctness of the amount of tax due as shown thereon. *See also, A.R. Barnes & Co. v. Department of Revenue*, 173 Ill. App. 3rd 826 (1st Dist. 1988). Once the Department establishes the *prima facie* correctness of the amount of tax due via admission into evidence of the Correction of Returns, the burden shifts to the taxpayer to show that such determination is incorrect. In order to overcome the presumption of validity attached to the Department's corrected returns, the taxpayer must produce competent evidence, identified

with its books and records showing that the Department's returns are incorrect. Copilevitz v. Department of Revenue, 41 Ill.2d 154 (1968).

On examination of the record in this case, the taxpayer has not presented competent evidence to prove that the color standards qualify for either the graphic arts exemption or the MM&E exemption. Accordingly, under the reasoning given below, this matter should be resolved in favor of the Department. In support thereof, I make the following conclusions.

Section 120/2-5(14) of the Retailers' Occupation Tax Act ("ROTA") exempts machinery and equipment used "primarily in the process of manufacturing or assembling tangible personal property for wholesale or retail sale or lease." Further, Section 2-45 of the ROTA defines certain terms as follows:

- (1) 'Manufacturing process' means the production of an article of tangible personal property whether the article is a finished product or an article for use in the process of manufacturing or assembling a different article of tangible personal property, by a procedure commonly regarded as manufacturing, processing, fabricating, or refining that changes some existing material or materials into a material with a different form, use, or name. ...

- (3) 'Machinery' means major mechanical machines or major components of those machines contributing to a manufacturing or assembling process.
- (4) 'Equipment' includes an independent device or tool separate from machinery but essential to an integrated manufacturing or assembly process...; any sub-unit or assembly comprising a component of any machinery or auxiliary, adjunct, or attachment parts of machinery, such as tools, dies, jigs, fixtures, patterns, and molds; and any parts that require periodic replacement in the course of normal operation: but does not include hand tools.

35 ILCS 120/2-45.

Department regulation § 130.330(c) governs the MM&E exemption. It reads in part as follows:

Machinery and Equipment

- 2) Machinery means major mechanical machines or major components of such machines contributing to a manufacturing or assembling process . . .
- 3) Equipment includes an independent device or tool separate from any machinery but essential to an integrated manufacturing or assembling process . . . The exemption does not include hand tools. . .

86 Ill. Admin. Code Ch. I, § 130.330(c).

The taxpayer also contends that the color standards as used by the printers qualify as exempt equipment under the graphic arts exemption. Section 2-5 of the ROTA exempts machinery and equipment used primarily for graphic arts production from Illinois sales and use taxes. Graphic arts production is defined as “printing by one or more of the common processes or graphic arts production services as those processes and services are defined in Major Group 27 of the U.S. Standard Industrial Classification Manual.” 35 ILCS 105/3-30. "Acme" packaging is printed using the Gravure method and Flexography. Tr. pp. 54-55. These methods are included within Major Group 27 and thus are considered graphic arts production. Priv. Ltr. Ruling 92-0649 (Dec. 10, 1992).

The Department has promulgated a regulation concerning the graphic arts exemption. Section 130.325(b) states as follows:

b) Graphic Arts Production

- 1) Graphic arts production means printing by one or more of the common processes or graphic arts production services as those processes and services are defined in Major Group 27 of the U.S. Standard Industrial Classification Manual. (Section 2-30 of the Act.) The exemption includes printing by letterpress, gravure, screen, engraving and flexography and includes printing trade services as typesetting, negative production, plate production, bookbinding, finishing, loose-leaf binder production and other services set forth in Major Group 27. This exemption extends only to machinery and equipment used in the act of production. Accordingly, no other type or kind of tangible personal property will qualify for the exemption, even though it may be used primarily in the graphic art business.
- 2) Machinery means major mechanical machines or major components of such machines contributing to graphic arts production. Equipment means any independent device or tool separate from any machinery but essential to the graphic arts production process; or any sub-unit or assembly comprising a component of any machinery or auxiliary, adjunct or attachment or parts of machinery. The exemption does not include hand tools, supplies lubricants, adhesives or solvents, ink, chemicals, dyes, acids or solutions, fuels, glasses, goggles, coveralls, aprons and masks, or such items as negatives, one time use printing plates as opposed to multiple use cylinders or lithographic plates, dies, etc., which are expendable supplies. This exemption does not include the sale of materials to a purchaser who manufactures such materials into an otherwise exempted type of graphic arts machinery or equipment.

86 Ill. Admin. Code Ch I, § 130.325(b).

The language of the MM&E exemption and the graphics art exemption is essentially identical in that both exemptions apply to “machinery and equipment.” Further, both exemptions define the terms in identical fashion. Taxpayer does not argue that the color standards qualify as machinery, it contends that the color standards constitute exempt equipment because they qualify as either a “tool” or a “device.” Since

the terms “tool” and “device” are not defined by the statute, it is necessary to determine whether the legislature intended this language to include, as exempt from the imposition of the ROT, the color standards which "PCA" produces and thereafter sells to "Acme".

When interpreting a statute, a determination of the intent of the legislature must be made so as to give it effect. Illinois Department of Revenue v. Country Gardens, Inc., 145 Ill. App.3d 49 (5th Dist. 1986). When ascertaining the legislature’s intent, the plain language of the statute is reviewed. The statutory language should be given its plain, ordinary, and accepted meaning, “grounded on the nature, object, and consequences that would result from construing it one way or another.” Pedigo v. Johnson, 130 Ill. App. 3d 392, 396 (4th Dist. 1985). If the language of the statute is unclear or ambiguous, an analysis must be made of the entire statute, with every part construed in connection with every other part, so as to create a harmonious whole. Department of Revenue v. Country Gardens, Inc., supra.

Since neither the term “tool” or “device” is defined in the statute, the terms’ common and accepted meaning must be ascertained. Webster’s Third New International Dictionary (1993) defines “device” as “a piece of equipment or a mechanism designed to serve a special purpose or perform a special function.” Examples included are “<a ~for measuring heat release> <an improved steering ~>” Webster’s at 618.

The terms “equipment” and “mechanism” are used within Webster’s definition of “device.” Webster’s defines “mechanism” as “a piece of machinery: a structure of working parts functioning together to produce an effect.” Examples included are “<the valve ~ to operate the valve when it is in the engine block--Joseph Heitner> < ~ of a watch>.” “Equipment” is defined by Webster as:

2 a: the physical resources serving to equip a person or thing <funds for buildings and ~> <the vocal ~ of a singer> <a new jail became part of the municipal ~—Amer. Guide Series: Va.>: as (1): the implements (as machinery or tools) used in an operation or activity: APPARATUS <where a tractor is standard ~><sports ~> (2): *all the fixed assets other than land and buildings of a business enterprise* <the plant, ~, and supplies of the factory>.

Webster's, supra (emphasis added).

When adopting a definition from Webster's, one must be mindful of the legislature's intent in allowing an exemption from machinery and equipment. The Illinois Supreme Court has recognized that the purpose of the original statute was to "give business a tax exemption on capital investment." Van's Material Company, Inc. v. The Department of Revenue, 131 Ill.2d 196, 215 (1989) *quoting* 81st Ill. Gen. Assem. House Proceedings, June 29, 1979 at 239 (statements of Representative Ewing). Taxpayer argues that Rep. Ewing's comment does not reflect the legislature's intention to limit the MM&E exemption to capital or fixed assets, i.e., depreciable machinery and equipment. It contends that the comments were made to support an amendment to the exemption that the General Assembly granted to ensure broad relief to manufacturers by requiring that the equipment need only be used "primarily" rather than "directly and exclusively" in the manufacturing process.

Despite taxpayer's contentions to the contrary, there is nothing to suggest that the MM&E or the graphic arts exemption should be "broadly construed" as taxpayer proposes. In fact, taxpayer's proposal is directly at odds with Illinois case law that provides tax exemptions are to be strictly construed against the taxpayer and in favor of the taxing body. Medcat Leasing v. Whitley, 253 Ill. App. 3d 801, 803 (4th Dist. 1993); Telco Leasing, inc. v. Allphin, 63 Ill.2d 305 (1976). Taxpayer clearly has the burden to

prove entitlement to an exemption with all doubts being resolved in favor of taxation. United Airlines, Inc. v. Johnson, 84 Ill.2d 446 (1981); Folett's Illinois Book & Supply Store, Inc. v. Isaacs, 27 Ill. 2d 600 (1963).

The definition of equipment in Webster's dictionary that plainly addresses the business environment, i.e., "fixed assets, other than land and buildings" is the definition put forth by the Department in this matter and is the definition that most closely ties in to the legislature's intent to benefit a manufacturing enterprise's capital investment. Van's, supra. Even when reviewing all of Webster's definitions, though, it is difficult to imagine that color standards were the type of object contemplated by the legislature when it chose the words "device" or "equipment."

According to the taxpayer the color standards qualify under Department regulation § 130.330(d)(3)(B) which provides that the following is an exempt use:

The use of machinery or equipment to guide or measure a direct and immediate physical change upon the tangible personal property to be sold, provided such function is an integral and essential part of tuning, verifying, or aligning the component parts of such property;

86 Ill. Admin. Code §130.330(d)(3)(B)

It argues that the color standards at issue guide or measure a direct and immediate physical change upon either the ink when used by the ink suppliers or upon the packaging materials when used by the printers. Taxpayer's contentions are misguided, however, because this regulation merely echoes the statutory requirement of exempting only machinery and equipment. To understand this particular regulation, consider how a color standard is used by an ink supplier in the process. While preparing the ink, the supplier compares a color standard with the color proof prepared from the work in process to

determine whether the ink color is satisfactory. Tr. pp. 42-47. If additional pigment is required, it is reasonable to assume that it must be measured and carefully placed into the existing mixture. Any machinery or equipment that is needed to “guide or measure” the additional pigment required to change the ink color may well be exempt under Department regulation 130.330(d)(3)(B) and ultimately by the statute itself. A color standard does not fall within the boundaries of the statutory definition of machinery or equipment because its function is distinctly different. A color standard is merely a sample, which may in fact, be hung on a wall similar to a picture, when comparing it to the color proof developed from the work in process. In fact, the color standards are, in essence, pictures of what the end product must look like. In order to qualify under this exemption, the tangible property must first be machinery or equipment. The color standards are neither.

The statute also refers to the term “tool” when defining equipment for the MM&E exemption as does the regulation when defining the same term for the graphic arts exemption. Once again this term is not defined. Webster’s defines the term “tool” as follows:

1 a : an instrument (as a hammer or saw) used or worked by hand: an instrument used by a handicraftsman or laborer in his work : implement
b (1) : the cutting or shaping part in a machine or machine tool (2) : a machine for shaping metal : MACHINE TOOL **c** : a particular kind of hand tool : as (1) a bookbinder’s instrument headed with a cut or engraved design with which impressions are made (as in finishing) (2) : a small brush used in painting window sashes **2 a** : an implement or object used in performing an operation or carrying on work of any kind : an instrument or apparatus necessary to a person in the practice of his vocation or profession <a barber’s chair, a photographer’s camera, a scholar’s books are all ~s> ...

Webster’s, supra.

Taxpayer may well argue that color standards fall within the definition 2a stated above. Such a broad reading, however, would mean that *every* object a manufacturer utilizes would qualify for an exemption which, as noted above, is directly at odds with the legislature's intent as stated in Van's, *supra* and Illinois case law that provides that tax exemptions are to be strictly construed against the taxpayer and in favor of the taxing body. Medcat Leasing v. Whitley, *supra*.

Given the appropriate narrow construction, it is apparent the MM&E exemption was intended to grant tax relief to manufacturers who invest and make capital expenditures in equipment. Color standards are undoubtedly used in the process of manufacturing, but these items cannot qualify for a MM&E or a graphics arts exemption on that basis alone since the legislature chose to specifically narrow the exemption to only "machinery and equipment." The color standards are not similar to the "tools, dies, jigs, fixtures, patterns and molds" which the statute specifically exempts because it recognizes that these are "auxiliary, adjunct, or attachment parts of machinery." *See*, 35 ILCS 120/2-45. The legislature's intent is further evident when it chose to narrowly construe the word "tool" by specifically not exempting hand tools even if, in fact, the hand tool has a direct and immediate change upon the tangible personal property being manufactured, thus further dispelling taxpayer's argument for a broad reading of the exemptions.

A color standard is no more than a picture or a blueprint given to the printers and ink suppliers, it is the criterion that "Acme" has set and which the printers and suppliers must achieve. Consider Webster's definition of the term "standard" which reads in part:

3 a : something that is established by authority, custom, or general consent as a model or example to be followed : CRITERION, TEST **b** : a definite level or degree of quality that is proper and adequate for a specific purpose

7 a : a carefully thought-out method of performing a task <auditing ~s>
b : carefully drawn specifications covering manufacturing material or equipment

Webster's, supra.

A color standard is simply a sample of the level of quality required by "Acme" for its packaging. Taxpayer goes to great lengths to show that although the color standards only cost between \$3 to \$15 a piece, their development requires technological preciseness, i.e., there is more to developing a color standard than merely swabbing paint upon cardboard. This argument is irrelevant, however, since when determining whether a MM&E or a graphic arts exemption applies, the focus must remain on the role the color standard fulfills while in the hands of both the printer and the ink supplier, not on the level of technology or cost required to establish the blueprint, sample, or formula.

An analysis of the statutory language reveals that that the color standards at issue in this matter simply do not qualify as exempt equipment under the MM&E or graphic arts exemption. Reviewing the statutory language and ascertaining the plain, ordinary and reasonable interpretation of the terms "device" and "tool" as defined in Webster's Third New International Dictionary does not warrant determining that color standards, which are essentially a blueprint or a picture of the set criterion, should be included within the definition of exempt equipment. The Department's exclusion of these color standards recognizes the distinctions between an item which is no more than a sample of the finished good's required appearance and a piece of machinery or equipment which has a direct and physical impact in the process of creating the ink or gum packaging.

Wherefore, for the reasons stated above, it is my recommendation that this matter be resolved in favor of the Department.

Date: May 4, 2001

Administrative Law Judge